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No.

In the Supreme Court of the United States

OCTOBER TERM, 1981

FEDERAL ENERGY REGULATORY COMMISSION,
PETITIONER

v.

MID-LOUISIANA GAS COMPANY, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTION PRESENTED

In Title I of the Natural Gas Policy Act of 1978, 15 U.S.C. (Supp. IV) 3301 *et seq.*, Congress established an intricate system of incentive pricing provisions, which are triggered by a "first sale" of natural gas. The question presented is whether Congress intended that a pipeline which produces gas that under "cost-of-service" rate methodology is sold at a price which over time recovers the pipeline's exploration and production costs and provides a reasonable return on investment, is automatically entitled to the higher prices established under Title I on the theory that an intracorporate transfer of that gas from the pipeline's production division to its transmission division necessarily constitutes a "first sale."

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MID-LOUISIANA GAS COMPANY., ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the Federal Energy Regulatory Commission, petitions for a writ of certiorari to review the judgments of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A-1 to A-15)[1] is reported at 664 F.2d 530. The orders of the Federal Energy Regulatory Commission (Pet. App. B-1 to B-13, B-14 to B-49 and B-50 to B-82) are not reported.

JURISDICTION

The judgments of the court of appeals (Pet. App. C-1; App., *infra*, 1a-2a) were entered on December 23, 1981. Timely petitions for rehearing were denied on February 5, 1982 (Pet. App. C-3 to C-4). Justice White extended the time for filing a petition for a writ of certiorari to and

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[1] "Pet. App." refers to the appendix to the petition in No. 81-1889.

including July 5, 1982 (a holiday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and 15 U.S.C. (Supp. IV) 3416(a)(4).

STATUTES INVOLVED

1. Section 2(20) of the Natural Gas Policy Act of 1978, 15 U.S.C. (Supp. IV) 3301(20), provides:

> The term "sale" means any sale, exchange, or other transfer for value.

2. Section 2(21) of the Natural Gas Policy Act of 1978, 15 U.S.C. (Supp. IV) 3301(21), provides:

> (A) General rule
>
> The term "first sale" means any sale of any volume of natural gas—
>
> (i) to any interstate pipeline or intrastate pipeline;
>
> (ii) to any local distribution company;
>
> (iii) to any person for use by such person;
>
> (iv) which precedes any sale described in clauses, (i), (ii), or (iii); and
>
> (v) which precedes or follows any sale described in clauses (i), (ii), (iii), or (iv) and is defined by the Commission as a first sale in order to prevent circumvention of any maximum lawful price established under this chapter.
>
> (B) Certain sales not included
>
> Clauses (i), (ii), (iii), or (iv) of subparagraph (A) shall not include the sale of any volume of natural gas by any interstate pipeline, intrastate pipeline, or local distribution company, or any affiliate thereof, unless such sale is attributable to volumes of natural gas produced by such interstate pipeline, intrastate pipeline, or local distribution company, or any affiliate thereof.

STATEMENT

A. The Regulatory Treatment Of Pipeline Production Under The Natural Gas Act

1. In 1938, Congress enacted the Natural Gas Act, 15 U.S.C. (& Supp. IV) 717 *et seq.*, which provides for federal regulation of the interstate transportation and sale for resale of natural gas. Soon thereafter, the Federal Power Commission[2] stated that the Natural Gas Act did not empower it to exercise regulatory authority over wellhead or field sales of natural gas by an independent producer to an interstate pipeline. *In re Columbian Fuel Corp.*, 2 F.P.C. 200, 206 (1940).[3] See *Permian Basin Area Rate Cases*, 390 U.S. 747, 756 n.7 (1968).

So matters stood until 1954, when this Court held, in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, that the Commission had jurisdiction under the Natural Gas Act to regulate independent producers (which are "natural-gas compan[ies]" within the meaning of Section 2(6) of the Act, 15 U.S.C. 717a(6)), simply by virtue of the fact that they sell the natural gas they produce in interstate commerce for resale. It soon became apparent, however, that traditional ratemaking methodology based on individualized "cost-of-service" pricing was inappropriate for regulating such producers. See *Permian Basin Area Rate Cases*, *supra*, 390 U.S. at 756-757. Accordingly, the Commission shifted to an area rate approach for regulating interstate sales for resale by independent producers. This method utilized a representative average

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[2] The Federal Power Commission was the predecessor of the Federal Energy Regulatory Commission. Both are referred to herein as the "Commission."

[3] The Commission's approach was predicated on Section 1(b) of that Act, 15 U.S.C. 717(b), which specifically precludes federal jurisdiction over the "production or gathering of natural gas."

cost of all producers in a particular area, rather than focusing on the individual costs of each entity subject to regulation. See *Wisconsin* v. *FPC*, 373 U.S. 294, 298-299 (1963). By this new method, the Commission sought to "employ price functionally, as a tool to encourage discovery and production of appropriate supplies of natural gas." *Permian Basin Area Rate Cases*, *supra*, 390 U.S. at 760. As a result, the area rates and the subsequently adopted national rates specified separate, fixed components for "Successful Well Costs" and "Dry Hole Costs." *National Rates For Jurisdictional Sales of Natural Gas*, 56 F.P.C. 509, 543-544 (1976), aff'd *sub nom. American Public Gas Association* v. *FPC*, 567 F.2d 1016 (D.C. Cir. 1977), cert. denied, 435 U.S. 907 (1978). An incentive was thereby provided: those independent producers that operated below the average cost levels on which the area rates were based earned a greater return, while those that operated at higher than average costs earned a lower return.

2. The Commission's approach under the Natural Gas Act to pipeline production took a different course. In *In re Canadian River Gas Co.*, 3 F.P.C. 32, 40 (1942), aff'd *sub nom. Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581 (1945), the Commission rejected a pipeline's contention that it was not subject to Commission jurisdiction "so far as it is engaged in the production and gathering of natural gas." Because the pipeline's production and gathering operations were an integral part of its total operations, the Commission concluded that the costs of the pipeline's production operations had to be taken into account in regulating the pipeline's rates and charges for the sale and transportation of gas in interstate commerce.[4] Thus,

[4] This conclusion was presaged in the Commission's jurisdictional decision in *In re Columbian Fuel Corp.*, *supra*, where the Commission differentiated between pipeline production and independent producer production. Its view was that "[w]here a big transporting

for pricing purposes the Commission treated the production and transportation of natural gas by an integrated pipeline as a single transaction, and the Commission sought to achieve its objectives by regulating the rate charged by the pipeline for sales to its distribution customers. In affirming *Canadian River*, this Court held that while the Commission has no jurisdiction per se over the production and gathering of natural gas, that statutory limitation did "not preclude the Commission from reflecting the production and gathering facilities of a natural gas company [*i.e.*, a pipeline] in the rate base and determining the expenses incident thereto for the purpose of determining the reasonableness of rates subject to its jurisdiction." *Colorado Interstate Gas Co.* v. *FPC*, *supra*, 324 U.S. at 603.

The upshot was that gas which a pipeline produced and then sold through its transmission system in "one wholesale * * * transaction" (*In re Columbian Fuel Corp.*, *supra*, 2 F.P.C. at 206) was subject to individualized cost-of-service regulation. Under that methodology, a pipeline computes the amount of revenues needed, on a test year basis, to cover its exploration and production costs (including dry-hole costs) plus the return sought on production investment (*i.e.*, rate base); this amount is then added to the revenue requirements for the pipeline's overall cost-of-service to be recovered through the pipeline's wholesale rates. (See Pet. App. B-21.) The net effect is to shift all risks to the consumers since cost-of-service methodology permits pipeline producers to recover all prudently incurred costs, relating not only to suc-

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company owned its own wells and gathering lines, there would be but one wholesale * * * transaction to bring under Federal regulation and all provisions of the Act involving production and gathering would apply." 2 F.P.C. at 206.

cessful drilling activities but also to "dry hole costs and other costs associated with unsuccessful and marginally successful ventures * * *" (*id.* at B-27).

In contrast to the Commission's treatment of pipeline produced gas that was sold downstream to distributing companies, when a pipeline producer sold its production directly in the field (a "field" or "wellhead" sale), usually to another pipeline, the Commission accorded those "off-system sales" independent producer pricing. As was the case with field sales by independent producers, such off-system sales were made pursuant to both a contract and a certificate, and the pipeline was required to file with the Commission a producer rate schedule covering the transaction. See, *e.g.*, *Tenneco Corp.*, 28 F.P.C. 382 (1962) (listing numerous field sale contracts, certificates and rate schedules covering sales by producing affiliate to parent transmission company).

3. In recognition of the risk-shifting effect of cost-of-service treatment (which led in the main to high cost gas) and in an effort to provide incentives to pipeline producers to find more gas at lower costs, the Commission announced in 1969 that with respect to future leases pipeline production would be priced on a parity with independently produced gas unless the pipeline justified cost-of-service treatment based on a showing of "special circumstances." *Pipeline Production Area Rate Proceeding (Phase I)*, 42 F.P.C. 738, 745 (1969), aff'd *sub nom. City of Chicago* v. *FPC*, 458 F.2d 731 (D.C. Cir. 1971), cert. denied, 405 U.S. 1074 (1972).[5] This parity pricing

[5] At the same time, the Commission emphasized that its two pre-existing policies remained unchanged: (a) area rates would be applied, as they had for some time, to pipeline production sold off-system to other pipelines; and (b) gas taken in a pipeline's system from pre-1969 leases would continue to be priced on a cost-of-service basis. 42 F.P.C. at 746.

policy continued through the 1970's. See, *e.g.*, *National Rates For Jurisdictional Sales of Natural Gas*, *supra*, 56 F.P.C. at 595; *id.* at 2784-2786 (on rehearing).

As a general matter, therefore, at the time of the enactment of the Natural Gas Policy Act of 1978, 15 U.S.C. (Supp. IV) 3301 *et seq.* (NGPA), pipeline producers received independent producer prices for off-system sales and for production from post-1969 or "new" leases (absent a showing of special circumstances), and cost-of-service treatment for production from all pre-1969 or "old" leases and some new leases under the special circumstances exception. [6]

B. The Pricing Scheme Adopted In The NGPA

Following the decision in *Phillips*, the Commission encountered significant difficulties in attempting to regulate independent producer sales "under the terms of an ill-suited statute." *Permian Basin Area Rate Cases*, *supra*, 390 U.S. at 756. These difficulties were not alleviated by area or national rate pricing. Rather, the market for natural gas soon divided into a regulated interstate market and several distinct, unregulated intrastate markets. By the late 1960's, in the face of a rapidly increasing demand for natural gas, this bifurcated system caused severe market distortions and adversely affected the dedication of reserves to the interstate system. By the 1970's, this artificial division had solidified and the na-

[6] Prior to enactment of the NGPA, the Commission determined that some production from old leases would also be subject to parity pricing. In the first national rate proceeding, the Commission provided that wells commenced subsequent to January 1, 1973, would be accorded national rate treatment regardless of the date the lease was acquired by a pipeline or pipeline affiliate. *Just and Reasonable National Rates For Sales of Natural Gas*, 52 F.P.C. 1604, 1634-1635 (1974).

tion's gas situation worsened. The prices for gas in the intrastate market were substantially higher than in the interstate market and there were serious shortages in the interstate market.

A central purpose of Congress in enacting the NGPA was to eliminate these dual markets and create a single national market where both interstate and intrastate purchasers would have equal access to new gas supplies without substantial price disparity. In order to encourage exploration for new gas supplies, Congress created additional incentives for independent producers.

Title I of the NGPA, entitled "Wellhead Pricing," serves this objective by establishing an intricate system of pricing provisions for "first sales" of natural gas.[7] Section 2(21)(A) of the Act, 15 U.S.C. (Supp. IV) 3301(21)(A), defines "first sale" generally as "any sale of any volume of natural gas" to a specified purchaser, including an interstate pipeline, an intrastate pipeline, a

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[7] Section 102 (15 U.S.C. (Supp. IV) 3312) prescribes the maximum lawful price for first sales of "new" natural gas and certain gas produced from the Outer Continental Shelf; Section 103 (15 U.S.C. (Supp. IV) 3313) prescribes the maximum lawful price for first sales of gas produced from new onshore production wells; Section 104 (15 U.S.C. (Supp. IV) 3314) imposes ceiling prices for first sales as the just and reasonable rate for natural gas that was flowing as of April 1977; Section 105 (15 U.S.C. (Supp. IV) 3315) covers first sales of natural gas flowing in intrastate commerce at the time of the enactment of the NGPA; Section 106 (15 U.S.C. (Supp. IV) 3316) establishes ceiling prices for both interstate and intrastate sales under "rollover" contracts; Section 107 (15 U.S.C. (Supp. IV) 3317) prescribes the maximum lawful price for first sales of high-cost gas; Section 108 (15 U.S.C. (Supp. IV) 3318) prescribes the maximum lawful price for "stripper well" natural gas; and Section 109 (15 U.S.C. (Supp. IV) 3319) establishes the first sale price for gas not covered by any of the foregoing categories.

local distribution company or an end user. However, Section 2(21)(B) provides that a "first sale"

> * * * shall not include the sale of any volume of natural gas by any interstate pipeline, intrastate pipeline, or local distribution company, or any affiliate thereof, *unless* such sale is attributable to volumes of natural gas produced by such interstate pipeline, intrastate pipeline, or local distribution company, or any affiliate thereof.

15 U.S.C. (Supp. IV) 3301(21)(B) (emphasis added). The Act defines "sale" as "any sale, exchange or other transfer for value." Section 2(20), 15 U.S.C. (Supp. IV) 3301(20).

C. The Commission's Rules

1. In Section 501 of the NGPA, 15 U.S.C. (Supp. IV) 3411, Congress authorized the Commission to administer the Act and define terms used in the Act. Shortly after the NGPA's enactment, the Commission issued interim regulations that denied "first sale" treatment to the routine sale by a pipeline from its general system supply, which ordinarily consists both of volumes produced by the pipeline and volumes purchased from others. 43 Fed. Reg. 56549-56550 (1978). The Commission found that for a sale to be "attributable" in the statutory sense to a pipeline's own production, the sale would have to be "comprised exclusively" of that production, as illustrated by sales made off-system at the wellhead or in the field to other pipelines. In Order No. 58, the Commission essentially reaffirmed the views expressed in the interim rules, with changes not here pertinent (Pet. App. B-1 to B-13).

On rehearing, some pipelines argued that the term "attributable" meant that a portion of each pipeline's sale from its system supply to a distributor customer should

be considered to consist of volumes produced by the pipeline.[8] Other pipelines argued that "attributable" meant imputable; they contended that the Commission should impute a sale at the wellhead to the movement of gas from a pipeline's producing division to its transmission division.

The Commission rejected both lines of argument. In Order No. 102 (Pet. App. B-50 to B-82), it concluded that the NGPA did not apply to the ordinary interstate pipeline sale. Rather, it found that the purpose of the "unless" clause of Section 2(21)(B) was to draw a "distinction between a pipeline or distributor's producer or field sales, and other sales that remain subject to Commission or state jurisdiction" (Pet. App. B-52). Thus, the Commission interpreted that clause as meaning that "[w]ellhead or field sales clearly are sales attributable to a pipeline's or distributor's own production; sales from a pipeline's system supply [which is] comprised of commingled volumes of purchased gas and pipeline production" are not (*id.* at B-53). The Commission also observed that if the NGPA applied to routine intrastate pipeline or local distribution company sales from mixed system supply, federal regulation would displace the retail ratemaking jurisdiction of state and local authorities over such mixed volume sales, an intrusion into the local retail markets that the Commission believed was not intended by Congress in enacting the NGPA (*id.* at B-62).

As for the contention that intracorporate transfers should be treated as "first sales" at the wellhead, the Commission acknowledged that it had the power to treat such transfers as sales (Pet. App. B-65). It refused to

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[8] Under this approach, if 20% of a pipeline's total system supply came from its own production, then 20% of each sale would be priced at "first sale" levels.

exercise that power, however, stressing that such transfers had not been considered sales under the Natural Gas Act inasmuch as there were no contracts or certificates applicable to such hypothetical transactions. The Commission found nothing in the NGPA that compelled it to regard as a sale "an event that is recorded solely on the books and records of the pipeline and that occurs without * * * contract, bargaining, or certification" (*id.* at B-66).

2. Following a separate rulemaking under the Natural Gas Act, the Commission issued Order No. 98 (Pet. App. B-14 to B-49), which continued the parity pricing approach for certain pipeline production dating from the Commission's 1969 ruling in *Pipeline Production Area Rate Proceeding (Phase I)*, *supra* (see pages 6-7). The Commission pointed out that "the NGPA left substantially intact the Commission's authority under the [Natural Gas Act] to regulate the rates and services of pipelines delivering gas in interstate commerce. The Congress left to the Commission the task of harmonizing its statutory mandate to implement the NGPA pricing scheme with its continuing authority under the [Natural Gas Act] to determine the price treatment of natural gas produced by interstate pipelines and sold in mixed volume sales" (Pet. App. B-24). In the Commission's view, the arguments for parity pricing have become even "more compelling" with the enactment of the NGPA *(ibid.)*. Thus, the Commission recognized that "[i]f pipeline producers were held to pre-NGPA prices, or were subject to a newly established cost-based nationwide rate, they would in many instances be unable to compete with independent producers in acquiring new leases. The resulting disincentive to pipeline production would deny the pipeline customers a more certain stream of additional supplies" (*id.* at B-25). Accordingly, the Commission ruled that "the existing policy of parity of treatment for pipeline producers should be continued in the context of the NGPA" (*id.* at B-26).

On the other hand, the Commission concluded that a similar approach was not warranted as to pipeline production that had been receiving cost-of-service treatment. The Commission pointed out (Pet. App. B-26 to B-27) that:

> [p]ipelines receiving such treatment have enjoyed the advantage of passing on to their customers the risks of the pipeline's production ventures. Pipelines have passed on the costs of acquiring leases and the costs of exploration and development, including dry hole costs and other costs associated with unsuccessful and marginally successful ventures, in exchange for assuring their customers the opportunity to enjoy the additional volumes resulting from successful ventures at a price determined on a cost-of-service basis. The Commission therefore will not extend pricing parity to pipeline production which prior to the enactment of the NGPA was valued on a cost-of-service basis rather than by reference to area or nationwide [rates].

On rehearing in Order No. 102, the Commission reiterated its views that "a pipeline whose production is valued on a cost-of-service basis will receive a rate that, over time, provides for the recovery of all prudently incurred costs plus a reasonable return on investment" (Pet. App. B-73). In the Commission's opinion, to "vary this policy * * * would deprive [pipeline customers] of price benefits they should receive in exchange for assuming the risk of a pipeline's production ventures" *(ibid.)*.

D. The Opinion Of The Court Of Appeals

The court of appeals vacated the Commission's orders (Pet. App. A-1 to A-15), holding that "Congress clearly intended for any production attributable to [a pipeline] * * * to be accorded first sale status under the NGPA and that Congress contemplated that the intracorporate transfer of pipeline production to the pipeline would be

treated as the first sale" (*id.* at A-15). Thus, the court concluded that the Commission had erred both in Order No. 58, in limiting "first sale" treatment only to sales of pipeline produced gas that are "comprised exclusively" of that production, and also in Order No. 98, in asserting Natural Gas Act jurisdiction under its parity pricing policy to pipeline production that the court believed was automatically entitled to NGPA prices under the "first sale" definition in the NGPA. The court refused to defer to the Commission, reasoning that the Commission's approach was not based on a longstanding interpretation and was not in an area of agency expertise, and, while it was a contemporaneous interpretation of a new statute, the Commission had "had no input into the development of the term 'first sale' " (*id.* at A-7).

In the court's view, the first clause of Section 2(21)(B) was meant to deny "first sale" status to downstream (non-wellhead) sales of gas to a pipeline's customer's (Pet. App. A-8),[9] whereas the "unless" clause was meant to ensure that all gas "attributable" to the pipeline's own production would be given "first sale" treatment (*id.* at A-9). In order to give effect to the second clause, the court held that "[i]n the context of pipeline production * * * the intracorporate transfer from the production division of the pipeline to the transportation division of the pipeline would constitute the first sale" (*id.* at A-11).[10] Otherwise,

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[9] To this extent, the court agreed with the Commission's analysis that the language of Section 2(21)(B) precluded giving "first sale" treatment to a sale from a pipeline to its customer even though that sale may have included pipeline produced gas, since it also contained purchased gas that had already received "first sale" treatment (Pet. App. A-8).

[10] The court noted that the Commission had refused to treat an intracorporate transfer as a first sale based on its view that no sale takes place in such a situation (Pet. App. A-14).

the court observed, virtually all pipeline produced gas would be excluded from NGPA pricing (*id.* at A-8, A-9).

The court summarily disposed of the Commission's approach with respect to cost-of-service gas, noting that the Commission's cost-of-service decisions constituted "exceptions to the application of area or national rates [and] represent historical practices the effect of which is continually diminished as early wells cease producing gas. They do not affect our decision" (Pet. App. A-3 n.1). As for the Commission's rule under the Natural Gas Act applying NGPA prices to pipeline production that was subject to the parity pricing policy, the court characterized it as "sophistic" and viewed it as "in no way justifying] departure from the congressional purpose in the first instance" (*id.* at A-9).

REASONS FOR GRANTING THE PETITION

This case presents an important question concerning the proper interpretation of a key provision in a new and complex statute enacted as part of a congressional effort to combat the nationwide energy crisis. See *FERC* v. *Mississippi*, No. 80-1749 (June 1, 1982), slip. op. 1 & n.2. Rejecting the construction of the statute by the agency charged with administering and enforcing it, the court of appeals has concluded that an intracorporate transfer of gas from a pipeline's production division to its transmission division qualifies as a "first sale," triggering the maximum lawful pricing provisions in Title I of the NGPA.

Undeniably, the so called "intracorporate transfer" theory is novel regulatory doctrine. Unlike the typical natural gas transaction, no contract governs the transfer and no Commission certificates have been issued or, for that matter, are required to be issued. Moreover, the effect of the decision below is to overturn more than 40

years of regulatory policy granting cost-of-service treatment to a substantial quantity of pipeline produced gas without any persuasive evidence that Congress intended to depart from this longstanding administrative practice. Unless overturned, the court of appeals' decision promises to grant pipeline producers an unjustified windfall at the expense of the nation's gas consumers, who, under the cost-of-service methodology, have borne the risks of the pipelines' production ventures. [11] Accordingly, review by this Court is clearly warranted.

1. The court of appeals agreed with the Commission that the term "first sale" as defined in Section 2(21) of the NGPA was intended to encompass only sales from the field or wellhead, and not "downstream" sales by a pipeline producer from its system supply to a distributing company (Pet. App. A-8). However, because it concluded that that reasoning, when taken to its logical conclusion, would make a "nullity" of the "unless" clause of Section 2(21)(B), the court adopted the fiction of "intracorporate transfer" as the equivalent of an actual wellhead or field sale. It is our submission that the Commission's reading of the statute more accurately reflects the congressional

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[11] The monetary impact of the court of appeals' decision is substantial. Interstate pipeline proposals filed with the Commission to implement the decision below indicate that the resulting increase in natural gas costs will exceed $100 million annually for the next several years.

The precise impact varies by pipeline depending on how much cost-of-service gas each pipeline owns and the NGPA pricing categories for which such gas qualifies. At the present time, where a pipeline has largely recouped all of its investment costs in these wells, consumers may be paying as little as $.20 per million Btu's for cost-of-service gas. Under the NGPA, as construed by the court of appeals, this same gas potentially would be re-priced at over $3.00 per million Btu's.

intent and that the court below erred in refusing to defer to the Commission's interpretation.

a. The Commission acknowledged that it had the authority, under Section 501 of the Act, 15 U.S.C. (Supp. IV) 3411, to treat the transfer of gas from a pipeline's production division to its transmission division as a "first sale" (Pet. App. B-65). However, the Commission declined to accord first sale status to an intracorporate transfer, noting that no contracts or certificates govern that transfer and that in administering the Natural Gas Act it had not treated such a transfer as a sale *(ibid.)*.

The Commission's decision is supported by the language of the NGPA. Before a transaction can qualify as a "first sale," it must, of course, amount to a "sale." The Commission's refusal to treat an intracorporate transfer as a sale is fully consistent with Section 2(20) of the Act, which defines "sale" as "a sale, exchange, or other transfer for value." It surely is curious to hold, as the court of appeals has here, that the Commission is required to find that this language encompasses a mere bookkeeping entry reflecting the commingling of a pipeline's produced gas with its purchased gas.

Moreover, the legislative history, while sparse, also supports the Commission's view. The very same history which the court found as "equating a first sale with a wellhead or field sale" (Pet. App. A-10 to A-11) indicates that what Congress had in mind as a "first sale" was an "arms-length" transaction in the usual sense of that term. Thus, the House Report on the proposed legislation stated:

> *Maximum Lawful Price—First Sale Concepts*
>
> Part D establishes "maximum lawful prices" applicable to certain categories of "first sales" of natural gas under natural gas sales contracts. The Committee intends that the term "first sales" be applied by

> the Federal Power Commission to the first transfer of natural gas for value in an *arms-length* transaction. Therefore, the first sale price is essentially a wellhead price.

H.R. Rep. No. 95-496 (Pt. 4), 95th Cong., 1st Sess. 103 (1977) (emphasis added).

b. Beyond this, the court below erred in completely disregarding the historical development of the regulation of pipeline production. The Commission's position, on the other hand, rests on the proposition that this is a case where " 'history is a teacher that is not to be ignored.' " *St. Paul Fire & Marine Insurance Co.* v. *Barry*, 438 U.S. 531, 545-546 (1978), quoting *Duparquet Co.* v. *Evans*, 297 U.S. 216, 221 (1936) (Cardozo, J.).

At the time of the enactment of the NGPA, pipeline production sold through a pipeline's own system was subject by the Commission to valuation on two distinct bases: cost-of-service or independent producer parity, with the major division between the two types of treatment turning on date of lease acquisition. On the other hand, pipeline production sold off-system directly from a producer-pipeline's own well was priced at field or parity prices irrespective of lease date. In short, where pipeline producers performed in a manner functionally equivalent to independent producers, they were granted incentives in the same manner as independent producers—those operating below the assumed average cost levels earned a greater return, while those operating at higher than average costs earned a lower return. Conversely, when pipelines transported the gas which they themselves produced they were treated not as producers but as pipelines deemed to be involved in "one wholesale * * * transaction" (*In re Columbian Fuel Corp.*, *supra*, 2 F.P.C. at 206).

It was this historical background that formed the basis for the Commission's orders in this case. The Commission

granted NGPA pricing to those pipeline producers that had been receiving independent producer prices under the area or national rates, in order to enhance their ability to compete with independent producers in the "continued development and additional production of natural gas" (Pet. App. B-25).[12] However, those pipeline producers that traditionally had been accorded cost-of-service treatment so that they could engage in "exploration and production activities while passing on the costs and risks of that investment to its purchasers" (*id.* at B-73) were continued on that basis.

2.a. Contrary to the conclusion of the court of appeals (Pet. App. A-9 to A-10), the two principal purposes of the NGPA—to create a unified market for natural gas and to provide incentive prices for new gas—are not at all inconsistent with the Commission's view. The court below asserted that the Commission's analysis would leave intact a "substantial vestige of the dual market structure Congress sought to eliminate" (*id.* at A-10). But there is

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[12] The Commission achieved this result in Order No. 98 through the "parity pricing" approach that it had developed under the Natural Gas Act. The court below deemed this to be a critical flaw in the Commission's analysis, terming it "sophistic," and adding that it is not an "agency's prerogative to alter a statutory scheme even if its alteration is as good or better than the congressional one. The fact that the agency gives back all or part of what it takes from the law's grant in no way justifies departure from the congressional purpose in the first instance." (Pet. App. A-9). But the court's comment does not advance the analysis because it merely assumes the invalidity of the Commission's approach. If the Commission was correct in concluding that it is not automatically required under the NGPA to treat an intracorporate transfer as a "first sale," then, contrary to the court of appeals, the Commission is free to exercise its authority under the Natural Gas Act to grant NGPA prices to certain pipeline produced gas in accordance with its parity pricing policy. That policy provides for the passing through to downstream customers of prices for pipeline produced gas at rates equivalent to those established for independent producers in the same area (see Pet. App. B-22).

nothing in the record of the rulemaking proceeding to substantiate the court's conclusion that if production by intrastate pipelines and local distribution companies were left to state regulation, the result would be the perpetuation of an insulated intrastate market. Furthermore, as the Commission made clear in this case (Pet. App. B-19 nn.8 & 9), the Commission could deal with such a problem pursuant to either its circumvention powers under Section 2(21)(A)(v), 15 U.S.C. (Supp. IV) 3301(21)(A)(v), or its discretionary authority under Section 501 of the Act, 15 U.S.C. (Supp. IV) 3411. [18] In any event, most of the production excluded from the NGPA by the Commission's interpretation is interstate production that was already subject to the Natural Gas Act. Clearly, the purpose of Section 2(21)(B) was not to extend price controls to that production.

The court of appeals also reasoned that the Commission's rules frustrate Congress' purpose of encouraging gas exploration because the rules do not grant pipeline producers the same incentive accorded independent producers in the form of higher prices. To be sure, Congress in the NGPA adopted a new pricing scheme for natural gas. But that does not mean that Congress intended to establish a system in which *all* gas would automatically

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[18] Section 2(21)(A)(v) gives the Commission the authority to define as a "first sale" any sale of any volume of natural gas which precedes or follows any sale described in Section 2(21)(A)(i) through (iv), in order to prevent circumvention of any maximum lawful price established under the NGPA. Section 501(a) gives the Commission broad rulemaking authority to carry out the purposes of the NGPA. The Conference Report states: "The authority to prescribe rules and orders necessary to carry out the provisions of this Act includes the authority to issue rules and orders necessary to prevent circumvention of the Act." H.R. Conf. Rep. No. 95-1752, 95th Cong., 2d Sess. 116 (1978). Under Section 504(a)(2), 15 U.S.C. (Supp. IV) 3414(a)(2), it is unlawful for any person "to * * * violate * * * any rule or order under this [Act]."

receive the maximum price allowed by statute. On the contrary, the Conference Report explained that the Act's "maximum lawful prices are ceiling prices only. In no case may a seller receive a higher price than his contract permits." H.R. Conf. Rep. No. 95-1752, 95th Cong., 2d Sess. 74 (1978). See Section 101(b)(9), 15 U.S.C. (Supp. IV) 3311(b)(9). See also *Pennzoil Co.* v. *FERC*, 645 F.2d 360 (5th Cir. 1981), cert. denied, No. 81-340 (Jan. 11, 1982). Thus, even independent producers do not always qualify for full incentive pricing where their contract prescribes a lower price. It would be anomalous to permit pipeline producers to qualify automatically for full NGPA prices by virtue of "intracorporate transfers" that are not governed by contract or by other indicia of a commercial transaction.

Indeed, the Fifth Circuit itself recently pointed out that "the NGPA did not intend indiscriminate application of the incentive." *Columbia Gas Development Corp.* v. *FERC*, 651 F.2d 1146, 1160 (1981). Instead, the court recognized that incentive pricing rests on the notion that "availability of a higher price [is] *necessary* to spur production * * *." *Pennzoil* v. *FERC*, 671 F.2d 119, 123 (1982) (emphasis in original). By the same token where—as is the case with cost-of-service gas—a pipeline producer recovers over time all prudently incurred costs (*e.g.*, exploration and production costs) and also earns a reasonable return on its investment, the pipeline already has received a substantial incentive and should be entitled to no more. To hold otherwise would be to grant pipeline producers an unjustified windfall at the expense of their customers.

To be sure, there is no discussion of cost-of-service pricing in the statute or in its legislative history. But it is inconceivable that Congress would have acted sub silentio to overturn 40 years of regulatory policy where that

policy was not part of the problem that Congress addressed in the legislation. [14]

b. In support of its "intracorporate transfer" theory, the court of appeals relied on hints in scattered provisions of the NGPA and its history (Pet. App. A-11 to A-13). This reliance is unavailing.

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[14] The decision in *Columbia Gas Development Corp.* v. *FERC*, *supra*, is particularly instructive in this regard. In that case, the Commission held that independent producers who held "optional procedure" certificates under the Natural Gas Act could not collect the higher ceiling rates under the NGPA for that gas. The certificate procedure had been developed by the Commission in an effort to stimulate producer production. Thus, under Commission regulations, independent producers could sign contracts for the production of gas at rates higher than the prevailing area-ceiling rate when the producer determined that the higher rate was sufficient incentive to justify new drilling. The Commission would then determine in a single proceeding whether the public convenience and necessity justified issuance of the certificate and whether the agreed-upon rate was just and reasonable. If it so determined, the agreed upon rate was not subject to challenge in a proceeding under Section 4 of the Natural Gas Act, 15 U.S.C. 717c.

In upholding the Commission's refusal to permit collection of NGPA prices for optional procedure certificated gas, the court stated (651 F.2d at 1157 n.13):

> Petitioners argue that the lack of any express statutory provision dealing with optional procedure certificates, and the lack of any discussion of those certificates in the legislative history, supports the view that Congress did not intend the singular treatment of optional procedure sales in Order Nos. 64 and 64-A. Such silence is not supportive of the petitioners, however. It would take express treatment of optional procedure certificate gas for such gas to fall outside the general principles of the NGPA that continue the certificate conditions.

This analysis has clear application to this case. Indeed, the rationale of *Columbia Gas* directly disposes of the claims of those pipeline producers which, after 1969, sought and obtained cost-of-service pricing under the "special circumstances" exception to the parity pricing policy.

First, the court pointed to a provision in Title II of the Act, which deals with incremental pricing. In order to mitigate the consumer impact of the increased wellhead prices under Title I, Title II generally provides for pass-through of the greatest portion of these increased costs to a discrete group of customers—industrial boiler fuel users. For these purposes, each pipeline is required to determine the cost of acquiring the gas it sells: the amount of these acquisition costs in excess of a specified threshold is isolated in a separate account and that amount is passed through to the industrial boiler fuel users (until such users are paying the same price they would be paying for alternative fuel). Thus, for purposes of Title II, the "acquisition cost" of gas is just that: the pipeline's cost of acquiring the gas.

Title II describes these acquisition costs as "first sale acquisition costs." Section 203 (15 U.S.C. (Supp. IV) 3343) provides two rules for determining a pipeline's acquisition costs for purposes of incremental pricing. First, Section 203(b)(1) provides generally that the "first sale acquisition cost" will be the price paid for gas "acquired in [a] first sale." However, Congress found it necessary to create a special rule for interstate pipeline production:

> For purposes of this section, in the case of any natural gas produced by an interstate pipeline * * * the first sale acquisition cost of such gas shall be determined in accordance with rules prescribed by the Commission.

Section 203(b)(2), 15 U.S.C. (Supp. IV) 3343(b)(2). As the Commission observed, this provision "differs notably from the general rule in that it omits any reference to 'price paid' and does not indicate that such gas will be 'acquired in a first sale' " (Pet. App. B-68).

These differences do not, however, establish that the rule of intracorporate transfer applies in the very different context of Title I. An explanatory statement prepared by several principal sponsors of the NGPA in the House of Representatives specifically states that "the language [of] * * * section 203(b)(2) is limited in its applicability to * * * Title II." 124 Cong. Rec. 38367 (1978). Furthermore, if the court's intracorporate transfer theory is correct, Section 203(b) would have been entirely superfluous. Thus, if Congress had intended an intracorporate transfer automatically to constitute a "first sale" for the purpose of triggering the pricing provisions of Title I, there would have been no need for any special rule empowering the Commission to determine the amount of pipeline production acquisition costs.

The court's reliance on the language of the Conference Report construing the Commission's rulemaking authority under Section 501 of the Act fares no better. That report states only that

> * * * the Commission *may* define terms such as "transfer for value" used in the definition of first sale; it *may* also establish rules applicable to intracorporate transactions under the first sale definition.

H.R. Conf. Rep. No. 95-1752, *supra*, at 116 (emphasis added). The court concluded, however, that "[t]his comment assumes that intracorporate transactions will fall within the first sale definition. The decision which Congress committed to the Commission's judgment was whether regulations were necessary to govern those transactions" (Pet. App. A-12 to A-13). We disagree. The court apparently read the phrase "under the first sale definition" as qualifying "intracorporate transactions." In our view, the more reasonable interpretation is that the Commission may establish rules "under the first sale definition" applicable to intracorporate transactions. This

reading is more in keeping with the discretionary language employed by Congress in describing the Commission's rulemaking authority under the Act.

3. As the foregoing discussion demonstrates, whatever support there is for the ruling of the court below, it is not readily discernible from the language or historical background of the NGPA. In these circumstances, the court below should, at the very least, have deferred to the agency's expertise. [15]

Unquestionably, courts "are the final authorities on issues of statutory construction" and "must reject administrative constructions of the statute * * * that are inconsistent with the statutory mandate or that frustrate the policy that Congress sought to implement." *FEC* v. *Democratic Senatorial Campaign Committee*, No. 80-939 (Nov. 10, 1981), slip op. 4-5. At the same time, however, a court may not simply interpret a statute as it thinks best; "rather the narrower inquiry [is] whether the Commission [interpretation] was 'sufficiently reasonable.' " *Id.* at 12. Under this standard, a court need not "find that the agency's construction was the only reasonable one or even the reading the court would have reached if the question initially had arisen in a judicial proceeding." *Ibid.* If the court below had applied these governing principles, we submit that it would have been compelled to uphold the Commission's interpretation of the Act. [16]

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[15] As the Fifth Circuit itself has pointed out: "The NGPA's complexity is but one more example of why federal courts show great deference to administrative interpretations of an agency's own statutes and limit their inquiry to whether the agency's actions are authorized and rational." *Ecee, Inc.* v. *FERC*, 645 F.2d 339, 360 (1981).

[16] The court of appeals gave several reasons for refusing to defer to the Commission (Pet. App. A-7): (1) the Commission's construction was not longstanding, (2) it did not concern an area particularly within the Commission's expertise, and (3) the Commission had no

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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Federal Energy Regulatory Commission

JULY 1982

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input into developing the term "first sale." This reasoning is erroneous. Although the "first sale" terminology is new, the Commission for many years had applied the provisions of the Natural Gas Act to "sales" of gas in interstate commerce. As the Commission observed, intracorporate transfers bear no resemblance to such sales. Moreover, during the legislative process leading up to enactment of the NGPA there was considerable interaction between the appropriate congressional committees and their staffs and the Commission.

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APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT*
UNIT A

No. 80-4010

F.E.R.C. No. RM80-6

CONSOLIDATED GAS SUPPLY CORPORATION, et al.,
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondents.

Petition For Review Of An Order Of The Federal Energy Regulatory Commission

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Before CHARLES CLARK, GARZA and SAM D. JOHNSON, Circuit Judges.

JUDGMENT

This cause came to be heard on petitions of Consolidated Gas Supply Corporation, et al for review of an order of the Federal Regulatory Commission, and was argued by counsel:

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that Order No. 98 of the Federal Energy Regulatory Commission is hereby vacated;

IT IS FURTHER ORDERED that Intervening-Respondents, Arizona Electric Power Corp. and Public Service Commission of the State of New York, to pay to petitioners, Kentucky-West Virginia Gas Company, Consolidated Gas

Supply Corporation and Kansas-Nebraska Natural Gas Gas Company, the costs on appeal.

December 23, 1981

A true copy:

Test: GILBERT F. GANUCHEAU
Clerk, U.S. Court of Appeals,
Fifth Circuit

By R. Adeline Barnes /s/
March 2 1982

New Orleans, Louisiana

ISSUED AS MANDATE: Mar 2 1982

*Former Fifth Circuit case, Section 9(1) of Public Law 96-452-, October 14, 1980.